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# Allocation Factors in Use in California

By FELIX S. WAHRHAFTIG\*

A determination that certain activities constitute a unitary business conducted in two or more states is but a means to an end—the allocating of a portion of the income from those activities to any one of those states through a formula rather than through a separate accounting system. Separate accounting has been tried and found wanting in this field. The extent to which formula allocation may be adequate to the task depends, of course, upon the selection of an appropriate formula and upon the manner in which the factors of that formula are applied.

So far as allocation of the income of a multistate unitary business is concerned, the form of the entity through which the business is conducted is quite immaterial. The business may be carried on by a resident or a nonresident individual, by a partnership composed of residents, nonresidents or both, or by a domestic corporation or a foreign corporation which either does or does not have a commercial domicile in the state. The business is conducted in most cases, of course, by a corporation, frequently by a group of affiliated corporations, and allocation will be discussed herein, accordingly, in terms of corporate activity.

What is essential to formula allocation is that the business be unitary in nature. Such allocation affords a means whereby the income from the unitary activity may be apportioned among the states wherein that activity occurs in accordance with a prescribed set of rules. Those rules will apply in an identical fashion to the income of a single corporation or to the combined income of two or more affiliated corporations whose activities in the aggregate constitute a unitary business.

The mechanics of formula allocation involve the ascertaining of the amount of the net income derived from the unitary business, hereinafter termed the unitary income, and the portion or percentage of the unitary business conducted within the taxing state. The percentage figure is obtained mathematically through the use of certain “factors” which are regarded as being indicative of the source of the income.

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While consideration will be given primarily to the selection and application of these factors, a brief discussion of some of the problems that have arisen in the determination of the unitary income may be helpful in that it will indicate the type of income subject to formula allocation.

### I. Unitary Income

Although a unitary business is a prerequisite to formula allocation, it does not follow that all the income of a corporation conducting a multistate unitary business is subject to such allocation. Along with its unitary business a corporation may be engaging in an activity not connected with that business or the corporation may be deriving income from a source separate and apart from the unitary business. Obviously, it is only the income actually attributable to the unitary business that is to be apportioned by formula.

Should a steel manufacturer operate a local candy store, to state an extreme example, only the income from the steel business would be subject to formula allocation. The income from the candy business would be determined through separate accounting and assigned to the state in which that business was situated. Unfortunately, the precise scope of unitary activity is not always so easily determined.

Businesses apparently unconnected may, on closer analysis, exhibit elements of dependency or contribution. The production and wholesale distribution of Christmas, anniversary and other greeting cards might not seem sufficiently related to the operation of a retail gift shop to constitute the two activities a unitary business. Yet, if the gift shop carries a large stock of the greeting cards and is operated primarily as a sales testing ground to obtain public reaction to new cards or new styles or types of cards, the card production activity and the gift shop activity might well be regarded as a unitary business even though sales of cards constituted only a small portion of the total sales of the gift shop.

The foregoing situations are set forth merely by way of illustration of one phase of the unitary income problem. The standards to be employed in ascertaining the existence of a unitary business or the inclusion in or exclusion from a unitary business of a particular activity are considered in detail in the preceding article.

### *Place of Income Derived From Intangibles*

The place of income derived from intangibles in the unitary income picture has produced some controversies in California. The special status occupied by intangibles under the *mobilia sequuntur personam* doctrine is the core of the difficulty. Reliance has been placed upon the doctrine at times by the tax administrator to exclude from unitary

income the income from intangibles of a domestic corporation and to assign the income in its entirety to this state. It has also been relied upon by a foreign corporation to assign the income to the state of its domicile and thereby to exclude it from the unitary income reachable in part by California.

Despite the fact that California Revenue and Taxation Code section 23040 states that income derived from sources within this state includes income from intangible property having a situs in this state, the State Board of Equalization<sup>1</sup> has not viewed the situs of the intangibles as governing the taxable status of the income therefrom. It has looked rather to whether that income was attributable to unitary business activity.

The Board has held, for example, that the interest income realized by a domestic corporation from conditional sales contracts negotiated with nonresidents outside this state in the course of the corporation's selling activity is includible in unitary income rather than assignable entirely to California, even though the contracts might have been subject to property taxation exclusively in California.<sup>2</sup> As the sales contracts were negotiated and executed in the course of the unitary business, it seems far more logical to throw the interest, along with the gain from the sales, into the unitary income hopper than to let the fictional *mobilia* doctrine govern. Interest on accounts receivable arising from sales in the course of the unitary business was also held to be unitary income.<sup>3</sup>

Similarly, the Board has determined that income received by a foreign corporation in the form of royalties for the use of copyrights is unitary income when the copyrights had been acquired and used as an integral part of a book publishing business.<sup>4</sup> Royalties for the use of patents acquired and used in the regular course of business of

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<sup>1</sup> The references herein to California decisions will be largely to those of the State Board of Equalization. The Board considers appeals from the action of the Franchise Tax Board on protests of taxpayers to proposed assessments of additional tax and on denials of claims for refund under the corporation and personal income tax laws. CAL. REV. & T.C. §§ 18593-18596, 19057-19061.1, 25666-25667, and 26075-26077. Its decisions under these laws far outnumber those of the California courts on allocation. Any reference herein to an appeal is one to a decision of the State Board of Equalization. The earlier decisions of the Board are not reported in the Commerce Clearing House and Prentice-Hall tax services, but citations to these services for California are given whenever possible.

<sup>2</sup> Appeal of Marcus-Lesoiné, Inc., CAL. ST. BD. OF EQUAL., Nov. 15, 1939.

<sup>3</sup> Appeal of M. Seller Co., CAL. ST. BD. OF EQUAL., Aug. 22, 1946; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13064.

<sup>4</sup> Appeal of Houghton Mifflin Co., CAL. ST. BD. OF EQUAL., March 28, 1946; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13606.

a manufacturer of the patented products received the same treatment.<sup>5</sup> Interest income from loans to employees was found to be unitary income on the basis of the rather ingenious showing that the loans were made for the purpose of increasing the efficiency of the employees and, accordingly, contributed to the operations of the unitary business.<sup>6</sup>

Interest received by an airline corporation on United States Treasury tax notes<sup>7</sup> was held, however, not includible in unitary income even though the notes could be and were used for the payment of federal income taxes on income from the corporation's unitary business.<sup>8</sup> The interest was regarded as flowing from an investment in government securities rather than from the operation of the airline business. The conditional sale contract interest decision was distinguished on the grounds that the contracts resulted directly from the selling activities of the corporation and the management and liquidation of the contracts were carried on as integral parts of the corporation's regular business operations. The tax note interest decision seems questionable, however, as there does not appear to have been any intent to withdraw the funds used to purchase the notes from the unitary business for purposes of a separate investment. The purpose seems rather to have been to keep those funds readily available in an income-producing form to satisfy a liability arising from the business.

The Board's determinations are not at variance with the decision in *Rainier Brewing Co. v. McColgan*,<sup>9</sup> dealing with royalties received by a California corporation under a contract transferring to a Washington corporation the exclusive right to manufacture and sell beer in Washington and Alaska under the "Rainier" label. The court held that the intangible to which the royalties were attributable had a situs

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<sup>5</sup> Appeal of St. Regis Paper Co., CAL. ST. BD. OF EQUAL., Dec. 16, 1958; CCH 2 CAL. TAX CASES ¶ 201-190; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13190; Appeal of Rockwell Mfg. Co., CAL. ST. BD. OF EQUAL., Feb. 19, 1958; CCH 2 CAL. TAX CASES ¶ 200-845; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13175; Appeal of National Cylinder Gas Co., ST. BD. OF EQUAL., Feb. 5, 1957; CCH 2 CAL. TAX CASES ¶ 200-656; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13159; Appeal of International Business Machines Corp., CAL. ST. BD. OF EQUAL., Oct. 7, 1954; CCH 1 CAL. TAX CASES ¶ 200-286; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13143.

<sup>6</sup> Appeal of American Snuff Co., CAL. ST. BD. OF EQUAL., April 20, 1960; CCH 3 CAL. TAX CASES ¶ 201-538; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13223.

<sup>7</sup> Interest on obligations of the United States, though immune from a state tax on net income, is includible in the measure of a state corporation franchise tax. *Tradesmens National Bank v. Oklahoma Tax Commission*, 309 U.S. 560 (1940).

<sup>8</sup> Appeal of Fibreboard Products, Inc., CAL. ST. BD. OF EQUAL., Feb. 17, 1959; CCH 2 CAL. TAX CASES ¶ 201-245; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13198 (also held interest on federal securities to be nonunitary income) Appeal of American Airlines, Inc., CAL. ST. BD. OF EQUAL., Dec. 18, 1952; CCH 1 CAL. TAX CASES ¶ 200-195; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13120.

<sup>9</sup> 94 Cal. App. 2d 118, 210 P.2d 233 (1949).

in California under the *mobilia* doctrine. It sustained, accordingly, the action of the Franchise Tax Commissioner in including the entire amount of the royalties in the measure of the California corporation's franchise tax liability on the basis of the statutory provision including in income from California sources income from intangibles having a situs in this state.

The taxpayer did not, however, engage in any business activity outside California and, with the possible exception of the royalties in question, was not receiving any income from sources outside the state. The situation was not, accordingly, that of a unitary business conducted in two or more states and the point at issue was not whether the royalties constituted a part of the unitary income of such a business. The assigning of the royalty income to California was, then, just a matter of determining, as the court did, that the intangible from which the income was derived had its situs in California rather than in Washington.

Assume, however, that the taxpayer had been conducting a multi-state unitary beer manufacturing and selling business but decided to transfer its right to use the "Rainier" label in Washington to the Washington corporation, rather than to enter and sell its products in that state. Would not the royalties then flow from the unitary business involving "Rainier" beer and form a part of the unitary income from that business? Certainly, the goodwill which the court found to be the intangible responsible for the royalties was an integral part of the unitary beer business.

On the basis of the action of the Franchise Tax Board and the State Board of Equalization in the patent and copyright royalty situations, it is believed that both Boards would determine that the "Rainier" royalties were unitary income in this instance. It is also believed that, despite the *Rainier Brewing Co.* decision, the California courts would sustain the view of the Boards that under Revenue and Taxation Code section 23040, assigning to this state, income from intangibles having a situs here, applies only to income not attributable to unitary activities and that the "Rainier" royalties were unitary income in the assumed situation.

Most of the states do not treat gains or losses from sales of capital assets as unitary income.<sup>10</sup> Arguments can be made both for the assignment of this type of income to the state of situs of the asset and, in some cases at least, for its inclusion in unitary income.<sup>11</sup> The Fran-

<sup>10</sup> Hartman, *State Taxation of Corporate Income From a Multistate Business*, 13 VAND. L. REV. 21, 60 (1959).

<sup>11</sup> See ALTMAN & KEESLING, *ALLOCATION OF INCOME IN STATE TAXATION*, at 83 (2d ed. 1950).

chise Tax Board regards the gain or loss as unitary income if the asset was used in the unitary business.<sup>12</sup>

### *Illustrative Examples*

The variety of the questions arising as respects unitary income is illustrated by the following decisions:

- Government project fees paid to a corporation by the United States for the services of managerial and technical personnel used in the construction and operation of government owned plants are unitary income, the skills of the personnel having been acquired in the course of the corporation's regular business operations.<sup>13</sup>
- Fees paid to a shoe manufacturer for a license to use a registered trade mark and for technical and styling advice, advertising advice, specifications and sample patterns and lasts are unitary income. Here, too, the taxpayer's ability to furnish the advice, service and "know how" arose out of its unitary business.<sup>14</sup>
- Unclaimed wages and deposits of employees for unreturned badges, tools and other equipment are unitary income.<sup>15</sup> The employees were engaged in the unitary business and their wages and the cost of the equipment had been included in the deductions from gross income in arriving at the net income of the unitary business.

As might be expected, these decisions add up merely to a general proposition that income derived from activities or transactions that arise from or as a result of, assist, contribute to or form an integral part of the general business operations of a corporation constitute a part of the unitary income of the corporation. The determination of the unitary or nonunitary character of the income from intangibles through the factual approach of the Franchise Tax Board and the State Board of Equalization produces a much fairer apportionment of this class of income than would be accomplished through reliance upon merely the *mobilia* or taxable situs doctrines.

## II. The Allocation Formula

The allocation formula provides the means for ascertaining the fraction or percentage of the unitary net income of a multistate business fairly attributable to the taxing state. The formula consists of cer-

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<sup>12</sup> A rather oblique statement to this effect appears in the allocation instructions on the corporation income return form.

<sup>13</sup> Appeal of Union Carbide & Carbon Corp., CAL. ST. BD. OF EQUAL., Aug. 19, 1957, rehearing July 22, 1958; CCH 2 CAL. TAX CASES ¶ 200-740; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13166.

<sup>14</sup> Appeal of The United States Shoe Corp., CAL. ST. BD. OF EQUAL., Dec. 16, 1959; CCH 2 CAL. TAX CASES ¶ 201-441; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13215.

<sup>15</sup> Appeal of Ford Motor Co., CAL. ST. BD. OF EQUAL., April 22, 1948; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13083.

tain factors which are selected on the basis that they are the elements producing the income and that the income has its source at the location of those elements.

Section 25101 of the California Revenue and Taxation Code wisely affords an extremely large measure of flexibility as respects the use of any particular allocation factors. The section directs that:

When the income of a taxpayer subject to the . . . [corporation franchise tax or the corporation income tax] is derived from or attributable to sources both within and without the state, the tax shall be measured by the net income derived from or attributable to sources within this state. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this state.

It will be observed that specific reference is made to the five factors of sales, purchases, expenses of manufacture, payroll and property. The statute grants the broadest possible discretion to the administrator for it authorizes allocation by reference to any of these or any other factors or by any other method. The sole restraint upon the exercise of this discretion is the restriction that the factors or the method of allocation employed be such as is fairly calculated to determine the net income derived from or attributable to California sources.

The "derived from California sources" phraseology has been employed as respects the corporation income tax since the enactment of that tax in 1937<sup>16</sup> and as respects the franchise tax since 1939. Prior to 1939, however, section 10 of the Bank and Corporation Franchise Tax Act<sup>17</sup> was phrased in terms of ascertaining through the allocation formula the portion of the income derived from business done in this state. This terminology was not employed for the corporation income tax as that tax was not imposed as a franchise tax on doing business as a corporation. The source phraseology was amended into section 10 of the Franchise Tax Act in 1939<sup>18</sup> to assure the greatest possible degree of uniformity in allocation of income for purposes of the two taxes. Virtually the same construction has been given to the source phraseology as had been given to the business done phraseology as respects the matter of allocation.

Factors which have been employed in other states include not only

<sup>16</sup> CAL. STAT. 1937 ch. 765 p. 2184.

<sup>17</sup> CAL. STAT. 1929 ch. 13 §10 p. 24, as amended by CAL. STAT. 1931, ch. 1066, § 4, p. 2226, and CAL. STAT. 1935 ch. 275 § 6, p. 965.

<sup>18</sup> CAL. STAT. 1939 ch. 1050 § 5 p. 2944.



the five listed in section 25101 but also gross receipts, average inventory, business or business done, costs and costs of sales.<sup>19</sup> The Franchise Tax Board and its predecessor, the Franchise Tax Commissioner, have prescribed, however, merely the three-factor formula of property, payroll and sales for general application.<sup>20</sup> Departures have been made from this formula in favor of others only to cover special situations for which the basic formula for some reason is inappropriate.

The field of formula allocation of income among states is one, fortunately, in which precision is neither expected nor required. It is recognized that, as a matter of practical tax administration, precision is impossible and rough approximation is sufficient.<sup>21</sup> The ideal method of allocation would not only assign to each state in which the unitary activity is conducted its fair share of the income from that activity but would also of necessity permit or result in the taxation of exactly 100 per cent, no more and no less, of that income in those states.

At least two considerations preclude the speedy adoption of any such method by all the states. In the first place, policy considerations do not point unerringly to a single or ideal formula. There is legitimate room for argument concerning not only the most effective formula but also the manner in which the factors of that formula should be applied. In the second place, the revenue interests of all the states would by no means best be served by a single formula. A manufacturing state, for example, may have the most to gain from a revenue standpoint by stressing property and manufacturing costs, a non-manufacturing state by stressing sales.

The three-factor formula of property, payroll and sales is employed by far more states than any other formula<sup>22</sup> and its use has been recommended as a means of achieving uniformity in allocation of income among states. It is conceivable that the studies and the report to be made by Congressional committees on or before July 1, 1962, pursuant to the Interstate Income Law enacted by Congress in 1959<sup>23</sup> following the decision of the United States Supreme Court in *Northwestern States Portland Cement Co. v. Minnesota*<sup>24</sup> will bring about at least some measure of uniformity through Congressional action.

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<sup>19</sup> The different formulas employed and the states using each are set forth in Hartman, *supra* note 10, at 65.

<sup>20</sup> 18 CAL. ADM. C. REG. 25101.

<sup>21</sup> *International Harvester Co. v. Evatt*, 329 U.S. 416 (1947); *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 238 P.2d 569, *appeal dismissed*, 343 U.S. 939 (1951); *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731, 215 P.2d 4, *appeal dismissed*, 340 U.S. 801 (1950).

<sup>22</sup> Hartman, *supra* note 10, at 65.

<sup>23</sup> 73 Stat. 555, U.S.C.A. §§ 381-384 (Poc. Supp. 1959).

<sup>24</sup> 358 U.S. 450 (1959).

### *The Three-factor Formula*

It is fundamental that the formula used in apportioning unitary income must give adequate weight to the essential elements responsible for the earning of the income.<sup>25</sup> What, then, are the considerations prompting the use generally in California, as well as in many other states, of a formula consisting of property, payroll and sales factors?

Property is included on the basis that capital is invested in a business as an income-producing element. It is not surprising to find that it is the most widely employed of all the factors.<sup>26</sup> Inasmuch as property as an allocation factor almost invariably means tangible property, real or personal, its location is generally fairly easy to ascertain. The principal problem in this regard is the mobile equipment of transportation companies. This is not to say, however, that other difficulties or controversies do not arise as respects the use of a property factor. Such matters as the inclusion in the factor of rented as well as owned property and the method of valuation of the property will be discussed later.

Payroll reflects the value of the personal services of individuals in the earning of income. Theoretically, at least, the income-earning value to the business of its employees is somewhat proportional to the salaries commanded by the various classes of those employees. Whether the value to the business of the employees is in any way proportional to the differentials existing among the states in wage and salary scales for the same type of service is, perhaps, somewhat questionable. As in the case of property, the payroll factor is one that for the most part possesses the virtue of ease of administration as respects both identification and location.

As business activity may be said to be directed at the obtaining of customers or markets, it is only to be expected that sales, which mark a successful effort toward this objective, would be regarded as an element indicating a source of income. In extensiveness of use, sales is second only to property as an allocation factor.<sup>27</sup> Considerable doubt as to the theoretical justification of sales as a factor is to be found, however, in the wide variations which exist among the states in fixing the location of a sale in applying this factor. The definitions or practices employed, which will be discussed subsequently, vary from assigning a sale to the state of origin of the goods to assigning it to the state of

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<sup>25</sup> *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 238 P.2d 569 (1951).

<sup>26</sup> Hartman, *supra* note 10, at 65, 67.

<sup>27</sup> Hartman, *supra* note 10, at 65, 71.

destination. Despite its wide usage, this factor probably poses the greatest threat to uniformity among the states in formula allocation. There is a strong temptation for a state to adopt rules for assigning sales most favorable to itself without regard to the cumulative effect of those rules and the rules of other states in assigning to the states collectively no more than 100 per cent of a taxpayer's sales.

The Franchise Tax Board is unquestionably committed to the use of the property-payroll-sales formula for a manufacturing and selling or purchasing and selling business. In fact, the tax return provided to all corporations makes provision only for the use of these factors. The Board has authorized or directed the use of other formulas for certain businesses, but, apart from such special situations, its regulations clearly contemplate allocation on the basis of the property, payroll and sales factors.<sup>28</sup> The success it has achieved in obtaining judicial approval of the use of this formula for a business involving the sale of personal property renders any departure from it for this type of business a rather remote possibility.

*El Dorado Oil Works v. McColgan*<sup>29</sup> involved allocation of the income of a California corporation engaged in the purchase of raw material, copra, in the Philippine Islands and the East Indies, the manufacture of coconut oil and meal in California and the sale of those products in California through its employees and in other states through independent brokers. In preparing its franchise tax return, it allocated income to California on the basis of all five factors listed in the statute. The Franchise Tax Commissioner, however, reallocated the income on the basis of only the property, payroll and sales factors.

The action of the Commissioner was sustained, the court concluding that the application of the three-factor formula was an honest effort to apportion to California that part of the net income fairly attributable to business done in the state, gave appropriate consideration to the elements entering into the business enterprise and was free from constitutional objection that it operated to tax extraterritorial values. The court rejected the taxpayer's position that the statute designated the five factors as a standard yardstick and that an alternative formula could be applied in the Commissioner's discretion only where the five-factor formula would not truly reflect the income-producing elements of the unitary business.

The court upheld the delegation to the Commissioner of authority to adopt a suitable method of allocation within the acceptable statutory standard of a method fairly calculated to assign to California that por-

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<sup>28</sup> 18 CAL. ADM. C. REG. 25101.

<sup>29</sup> 34 Cal. 2d 731, 215 P.2d 4 (1950).

tion of the net income reasonably attributable to business done here. *Butler Brothers v. McColgan*<sup>30</sup> was said to have recognized the three factor formula as sufficiently diversified to reflect the relative contribution of out-of-state activities to the production of the total unitary income and to allocate to California its just proportion of that income. *Edison California Stores v. McColgan*<sup>31</sup> was declared to have "settled" the "fairness" of that formula..

In urging the arbitrary result of the Commissioner's action, the taxpayer complained only of the omission of the factor of purchases. It had offered evidence that its profits arose from its purchasing, as well as its manufacturing and selling activities and contended that failure to recognize the effect of its favorable foreign purchases through use of a purchases factor unreasonably increased its California income. Conceding, however, that the foreign purchases contributed to the profits of the business, the court found that sufficient recognition had been given to them as a matter of allocation through the inclusion in the payroll factor of the compensation of the employees engaged out-of-state in the purchasing activity and the inclusion in the property factor of the foreign purchased copra awaiting shipment or en route to California.

The grounds advanced by the court in rejecting purchases as a separate factor would ordinarily be equally appropriate to the rejection of manufacturing costs as a separate factor. The State Board of Equalization, in an opinion prior to the *El Dorado Oil* case, had denied a tobacco manufacturer the right to use purchases and manufacturing costs as factors and upheld a reallocation on the basis of the three-factor formula.<sup>32</sup> The contention of a drug manufacturer that cost of manufacturing and cost of selling should be included as factors along with the usual three was similarly rejected by the Board.<sup>33</sup>

The elimination of the payroll factor and allocation of unitary net income before the deduction of salaries on the basis of only property and sales with a deduction from the income so allocated to California of the actual California payroll and wages met a similar fate.<sup>34</sup> The merchandising firm urging this method offered evidence of higher salary costs in California than elsewhere as the ground of its attack on the result reached through the three-factor formula. A plea for the

<sup>30</sup> 315 U.S. 501 (1942).

<sup>31</sup> 30 Cal. 2d 472, 183 P.2d 16 (1947).

<sup>32</sup> Appeal of R. J. Reynolds Tobacco Co., CAL. ST. BD. OF EQUAL., Jan. 19, 1931.

<sup>33</sup> Appeal of the Upjohn Co., CAL. ST. BD. OF EQUAL., May 20, 1948; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13085.

<sup>34</sup> Appeal of S. H. Kress & Co., CAL. ST. BD. OF EQUAL., Dec. 8, 1955; CCH 2 CAL. TAX CASES ¶ 200-461; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13149.

elimination of both the property and payroll factors and the use of the sales factor only in the allocation of manufacturing and selling income also proved unavailing.<sup>35</sup>

### *Deviations From the Three-factor Formula*

While the administrative agency is understandably reluctant, in view of these authorities, to depart from the property-payroll-sales formula in the allocation of the income from a business involving the sale of personal property, it will do so in the case of certain other types of activity. Its regulation on allocation expressly provides for the omission of the property factor in the case of personal service organizations, such as advertising agencies and business management firms, to which property is not a material income-producing factor.<sup>36</sup> Allocation of the unitary income of such service businesses is generally made, accordingly, on the basis of a payroll-sales formula even though small amounts of property, such as desks, typewriters and other office furnishings and supplies are used in the business.

The absence of hard and fast rules in the employment of any particular formula is illustrated by the decision of the State Board of Equalization in the *Appeal of Farmers Underwriters Association*.<sup>37</sup> The taxpayer was engaged in selling insurance and contended that the property factor should not be utilized in determining its income allocable to California inasmuch as it was a service corporation. The Board, however, upheld the administrator's use of the property factor as it appeared that the taxpayer used in its business a substantial amount of property consisting principally of land and buildings, furniture, office equipment and supplies and motor vehicles. In other words, the property factor is to be omitted only when property is held in such limited amounts as not to constitute in reality an income-producing factor, and not merely on the basis of the nature of the business conducted.

Certain businesses by their very nature require a special formula. The factors of average loans outstanding, payroll and interest earned have been applied in the allocation of the incomes of corporations engaged in making small loans<sup>38</sup> and livestock loans.<sup>39</sup> A refrigerator

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<sup>35</sup> Appeal of New Jersey Zinc Sales Co., CAL. ST. BD. OF EQUAL., June 14, 1943; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13017.

<sup>36</sup> 18 CAL. ADM. C. REG. 25101.

<sup>37</sup> CAL. ST. BD. OF EQUAL., Feb. 18, 1953; CCH 1 CAL. TAX CASES ¶ 200-205; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13129.

<sup>38</sup> Appeal of Public Finance Co., CAL. ST. BD. OF EQUAL., Dec. 29, 1958; CCH 2 CAL. TAX CASES ¶ 201-205; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13194.

<sup>39</sup> Appeal of Tri-State Livestock Credit Corp., CAL. ST. BD. OF EQUAL., April 4, 1960; CCH 3 CAL. TAX CASES ¶ 201-533; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13219.

car renting company sought to allocate its income solely on the basis of the ratio of the miles which the cars it had leased to railroads were hauled in California bore to the total miles such cars were hauled. The Commissioner agreed that the mileage factor was an appropriate one, but he simply substituted it for the sales factor and allocated on the basis of a property-payroll-mileage formula. It is readily apparent from the facts set forth in the opinion of the court sustaining this formula that property and payroll were substantial income-producing elements in the business.<sup>40</sup>

### *Weight and Percentage of Factors*

Almost without exception equal weight has been given in California to the allocation factors employed. This practice has undoubtedly been due in large part to the difficulties involved in doing otherwise. It is impossible to believe that each factor not only is as equally productive of income as its co-factors in every type of business but is also equally effective in fixing the locale of the income of those types of business. During the war years the administrator gave recognition to the fact that sales to the United States of scarce products required hardly any sales effort by giving only one-half the weight to such sales as to other sales of the manufacturer. Inasmuch as the supply and demand situation for many products was such that they were being sold only on a priority basis, it might even have been logical to exclude sales as a factor entirely and allocate on a property-payroll formula.

As equal weight is to be given to each factor, it is essential that a percentage figure be obtained for each factor individually and that the average of the separate percentages then be found. Thus, if California property constitutes 10 per cent of total property, California payroll 20 per cent of total payroll and California sales 30 per cent of total sales, 20 per cent of the unitary income is to be allocated to this state. The State Board of Equalization at an early date rejected the contention of a taxpayer that the California portion of the total business should be obtained by adding together the California property, payroll and sales and dividing the sum obtained by the amount of the total property, payroll and sales.<sup>41</sup>

Running through all the judicial decisions and those of the State Board of Equalization sustaining the tax administrator's allocation of income is the theme, generally in the words of the *Butler Brothers* decision, that "[O]ne who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it

<sup>40</sup> *Pacific Fruit Express Co. v. McColgan*, 67 Cal. App. 2d 93, 153 P.2d 607 (1944).

<sup>41</sup> *Appeal of Marchant Calculating Machine Co.*, CAL. ST. Bd. OF EQUAL., 1931.

results in extraterritorial values being taxed."<sup>42</sup> Attacks on the administrator's formula through the separate accounting route or through a contention that other or additional factors should be employed have invariably failed to surmount the burden of proof position of the state.<sup>43</sup> In fact, so many of these attacks have floundered that it may be said virtually as a matter of law that the property-payroll-sales formula fairly apportions to this state its fair share of the income of a business engaged in the sale of personal property.

### *The Interstate Income Law*

The Interstate Income Law<sup>44</sup> recently adopted by Congress complicates allocation of income in certain instances for purposes of the California corporation income tax. That law is being discussed in another article so reference will be made here only to the allocation problem. Prior to the enactment of the law, the Franchise Tax Board would have allocated to this state a portion of the income of a foreign corporation regularly sending employees into California to solicit orders for sales of tangible personal property, the orders being sent outside the state for approval or rejection, and, if approved, being filled by shipment or delivery from a point outside California. The Board would in this case have assigned some payroll and some sales to California.

Since the enactment of the law, California is precluded from applying its corporation income tax in this manner. But what is the California position to be as respects the converse situation of a domestic corporation sending its employees into other states so to solicit orders to be filled through interstate shipments? Although the other states can no longer apply their corporation income taxes to some portion of the corporation's income, is California still to assign to itself only the same proportion of payroll and sales as it had previously?

The answer would seem to be yes, in the absence of a change in the California allocation statute. That statute still subjects to taxation in this state only income derived from California sources. Payroll and sales in or out of California are still regarded as indicative of the source of income. The restrictive effect of the Congressional act would seem to have no effect upon allocation of income to California under the law of this state. The net effect of the Congressional intervention probably

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<sup>42</sup> 315 U.S. 501, 507 (1942).

<sup>43</sup> *Butler Bros. v. McColgan*, 315 U.S. 501 (1942); *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214, 238 P.2d 569 (1951); *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731, 215 P.2d 4 (1950); *Edison California Stores v. McColgan*, 30 Cal. 2d. 472, 183 P.2d 16 (1947).

<sup>44</sup> 73 Stat. 555, 15 U.S.C.A. §§ 381-384 (Supp. 1959).

will be to grant at least temporary tax immunity and tax relief to corporations conducting an interstate operation within the confines of the Interstate Income Law without requiring those corporations to assume any larger tax liability to any other state. Such a corporation undoubtedly will avoid taxation by the states collectively on a portion of its net income. It is doubtful whether a state will seek to offset the taxes it is unable to collect from foreign corporations by the collection of larger amounts of tax from its domestic corporations even though such action would not subject the domestic corporations to tax on over 100 per cent of their unitary incomes.

### III. The Factors of the Formula

The adoption of a particular allocation formula by a state by no means determines in itself the manner in which income will be apportioned to that state. Each factor is susceptible of definition or treatment in many different ways so the adoption by two or more states of the same formula does not assure uniformity of application of that formula. It is as important, accordingly, to know the definition of each factor or the rules of inclusion and exclusion followed by a state as to each factor as it is to know the factors constituting the allocation formula of the state.

#### A. *Property*

It is customarily said that "property" for allocation formula purposes includes all real and tangible personal property devoted to the unitary business. Thus, the term would include all land, buildings, machinery, equipment, inventories and other property used in the production of the unitary income. An eastern plant used in a unitary business is includible in the property factor as out-of-state property even though the goods manufactured in that plant are not sold in California.<sup>45</sup>

The California statutory provision on allocation refers specifically to tangible property and it might be thought, accordingly, that intangibles are to be excluded from the property factor. Nevertheless, the "work in progress" of a corporation engaged in the publication of city directories has been held includible in the property factor.<sup>46</sup> This item, representing the cost of canvassers' salaries, engraving and art work, printing, proofreading, revising and similar services, was likened to the partially completed products of a manufacturer. The statute offered

<sup>45</sup> Appeal of American Writing Paper Corp., CAL. ST. BD. OF EQUAL., 1952, CCH 1 CAL. TAX CASES ¶ 200-169; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13114.

<sup>46</sup> Appeal of R. L. Polk & Co., CAL. ST. BD. OF EQUAL., Oct. 26, 1944; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13055.



no insurmountable obstacle as it authorized other methods of allocation. To some extent, of course, the work in progress had advanced to a tangible personal property status, but, in any event, the inclusion of the item as property cannot be said to be unreasonable in view of the nature of the business activity.

The inclusion of rented, along with owned, property in the property factor has been the principal policy consideration confronting the states.<sup>47</sup> California has consistently excluded rented property,<sup>48</sup> its practice being similar to that of about half of the states using a property factor.<sup>49</sup> The argument for inclusion usually is expressed in terms that income is derived from the use of property irrespective of whether the property is owned or rented. Inclusion is also said to be desirable as a means of avoiding the possibility of making it advantageous to rent rather than to own property. The argument to the contrary centers about the view that property is employed as a factor because capital is invested in a business in the expectation of a return thereon. This view is considerably undercut, however, by the fact that when only owned property is included, it is not valued on the basis of the owner's actual capital investment therein.

While the mere reference to property used in the unitary business serves to exclude from the property factor that held as an investment outside the unitary business, it fails to disclose the time at which property acquires a used-in-the-unitary-business status. The ruling of the Franchise Tax Board that a building is not to be included in the factor until it is actually used in the business,<sup>50</sup> i.e., is not includible while in the course of construction, seems questionable. Presumably, the land on which the building is being constructed is not includible either until the building is ready for occupancy. The ruling is undoubtedly based on the notion that the building does not produce income until it is actually used. But the fact of the matter is that the capital investment is being made throughout the period of construction and the building would not be constructed at all if the corporation did not anticipate a suitable return upon its investment therein from the time that investment was first entered upon.

Timber lands owned by a lumber company but on which timber was not currently being cut were held by the State Board of Equaliza-

<sup>47</sup> The matter is discussed in *ALTMAN & KEESLING*, *supra* note 11, at 110.

<sup>48</sup> 18 CAL. ADM. C. Reg. 25101. Appeal of Douglas Aircraft Co., CAL. ST. BD. OF EQUAL., 1952; CCH 1 CAL. TAX CASES ¶ 200-188; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13123; Appeal of Art Rattan Works, CAL. ST. BD. OF EQUAL., Aug. 24, 1944; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13052.

<sup>49</sup> Hartman, *supra* note 10, at 67.

<sup>50</sup> 18 CAL. ADM. C. Reg. 25101.

tion to be includible in the property factor.<sup>51</sup> The Board pointed out that timber lands cannot be acquired on a moment's notice and that it was necessary for the company to have a source of timber in reserve and available for use as necessity might require. The timber lands had been acquired and were being held for use in the lumber business. The same reasoning would require the inclusion in the property factor of a building under construction and the land upon which it is situated if the land and building are being acquired for use in the unitary business. Buildings do not spring up on a moment's notice and certainly a building under construction for use in a business cannot be said to represent an investment outside or separate and apart from that business.

If property is permanently withdrawn from unitary use, it is, of course, to be omitted from the property factor.<sup>52</sup> Property which is idle only temporarily, however, should be included if it was an integral part of the unitary business and while idle is held available and ready for return to the unitary use as soon as conditions permit or require.<sup>53</sup> A plant temporarily idle because the products may be produced more effectively at another plant is not at the moment producing any income. The rulings on the partially completed and temporarily idle properties, accordingly, appear inconsistent.

### *In-State or Out of State?*

The foregoing discussion relates to the property to be included in the property factor. The question also arises of the location of the property, i.e., is it California or out-of-state property? Real estate and permanently located tangible personal property obviously present no problem. Some method must be applied, however, for locating such property as railroad cars, trucks and buses, airplanes and steamships operating in interstate or foreign commerce.

Railroad cars are apportioned on a mileage basis, i.e., the state is assigned that percentage of the total cars which the mileage of the company in California bears to its total mileage. Trucks and buses are assigned in a somewhat similar fashion.<sup>54</sup>

Ocean-going vessels and airplanes present some special problems. For many years California sought to allocate the income of steamship

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<sup>51</sup> Appeal of E. K. Wood Lumber Co., CAL. ST. BD. OF EQUAL., July 15, 1943; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13028.

<sup>52</sup> 18 CAL. ADM. C. Reg. 25101.

<sup>53</sup> 18 CAL. ADM. C. Reg. 25101. Appeal of St. Regis Paper Co., CAL. ST. BD. OF EQUAL., Dec. 16, 1958; CCH 2 CAL. TAX CASES ¶ 201-190; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13190; Appeal of Art Rattan Works, CAL. ST. BD. OF EQUAL., Aug. 24, 1944; P-H STATE & LOCAL SERV. Cal. ¶ 13052.

<sup>54</sup> 18 CAL. ADM. C. Reg. 25101.

companies in such a way that all the income would be assigned to states or counties in which the companies operated or otherwise conducted their activities. A three-factor formula of property, payroll and gross receipts was used, but the property and payroll factors were defined so as not to assign any of the vessels or wages of vessel employees to the high seas. A so-called port-day rule achieved this objective as to vessels by apportioning them to the state on the basis of the ratio of the number of port-days in California to the total port-days of the vessels.

The State Board of Equalization, expressing agreement with an opinion of the California Attorney General, upheld a reallocation of income made under this rule.<sup>55</sup> The statutory provision subjecting to tax only net income from California sources was construed in the light of the constitutional principle restricting the jurisdiction of a state to tax income of a foreign corporation derived from sources within other states or foreign countries. The avoidance of double taxation purpose of this principle was not breached by a method of allocation which did not assign any income to the high seas. Strong statutory support for the port-day rule was afforded by the provision of Revenue and Taxation Code<sup>56</sup> section 25101 before 1957 that income from business carried on within and without the state should ". . . be allocated in such a manner as is fairly calculated to apportion such income among the states or countries in which such business is conducted."

The port-day rule subsequently suffered a legislative defeat. In 1957, the above-quoted language was deleted from section 25101 and the following proviso was inserted: ". . . provided, however, that any such factors or other method of allocation shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not such transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country."<sup>57</sup> The regulations now provide, accordingly, that vessels shall be apportioned to the state on the basis of the ratio of the number of voyage days which the ship was within this state bears to the number of days of voyages of the ship during the tax period. Voyage days mean the days a ship is in operation for the purpose of transporting freight, passengers or other cargo, including all sailing days, all days in port while loading and unloading and all days that

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<sup>55</sup> Appeal of American President Lines, Ltd., CAL. ST. BD. OF EQUAL., Dec. 18, 1952; CCH 1 CAL. TAX CASES ¶ 200-193; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13121.

<sup>56</sup> Cal. Stat. 1955, ch. 938, § 20, p. 1649.

<sup>57</sup> Added Cal. Stat. 1957, ch. 2097, § 2, p. 3722.

the ship is laid up for ordinary repairs, refueling or provisioning.<sup>58</sup>

A California location is given to a portion of an airline's fleet of planes operating between this state and other states or foreign countries on the basis of the ratio of California revenue passenger miles to total revenue passenger miles and California revenue ton miles to total revenue ton miles. Even prior to the 1957 amendment to section 25101, the Franchise Tax Board had used revenue miles as a basis for assigning a portion of an interstate fleet to this state.<sup>59</sup> The effect of the method now being used is, of course, to attribute a portion of the planes to the "bridge" states over which the planes operate but in which the airline does not make any landings or otherwise engage in business activities or to the high seas.

Closely allied to the vessel and plane location problem is that of property en route as cargo. Considerable support to the proposition that such property while physically outside this state should be assigned an out-of-state location is afforded by the *El Dorado Oil Works* decision.<sup>60</sup> In rejecting the taxpayer's position that the factor of purchases should be included in the allocation factor, the court stated that consideration had been given to purchases as an income-producing factor through the inclusion in the property factor of the foreign purchased copra awaiting shipment or enroute to the taxpayer's manufacturing plant in this state. The State Board of Equalization, however, in the *Appeal of Ames Harris Neville Co.*<sup>61</sup> held that jute purchased by the company in India through independent brokers for use in its plants at San Francisco and at Portland, Oregon, and either aboard ships on the high seas or in Indian ports awaiting shipment was correctly assigned to California by the tax administrator.

Although the Board cited the *El Dorado* case for the upholding of the broad discretion conferred on the administrator as to allocation, it did not refer to the portion of the opinion relating to the copra awaiting shipment or en route. The Board's opinion may well be correct inasmuch as the statutory allocation provision then contained the sentence, deleted in 1957, directing allocation in such a manner as to apportion the income among the states or countries in which the business was conducted. Despite the deletion of this provision, the Franchise Tax Board still follows the practice upheld in the *Appeal of Ames Harris Neville Co.*

<sup>58</sup> 18 CAL. ADM. C. REG. 25101.

<sup>59</sup> *Appeal of American Airlines, Inc.*, CAL. ST. BD. OF EQUAL., Dec. 18, 1952; CCH 1 CAL. TAX CASES ¶ 200-195; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13120.

<sup>60</sup> 34 Cal. 2d 731, 215 P.2d 4, *appeal dismissed*, 340 U.S. 801 (1950).

<sup>61</sup> CAL. ST. BD. OF EQUAL., Nov. 21, 1957; CCH 2 CAL. TAX CASES ¶ 200-753; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13171.

### *Assignment of Values*

After the items of property used in the unitary business have been located either within or without California, the problem arises of assigning values to the property. California, in common with most of the states, uses the adjusted basis for state tax purposes, usually the book value, of the properties. The regulations provide ". . . Generally the value of assets used in the formula should be computed on a monthly average by adding the ending monthly balances and dividing by 12. However, where the business has been in operation throughout the entire year with no unusual seasonal fluctuations, opening and closing values may be used by the taxpayer."<sup>62</sup> The use of the monthly balances or the opening and closing values obviates the need for actual value determinations. Similarly, the exclusion of rented property from the property factor makes it unnecessary to assign values to such property. The states which include rented property generally derive the value of the property from the rental paid, e.g., the property is valued at eight times the annual gross rent.

Admittedly, the use of adjusted basis for allocation purposes is somewhat unrealistic and not necessarily indicative of the source of income. The tremendous growth of California during and after World War II and the attendant construction of new plants and other properties at higher costs than similar but older properties in other sections of the country brought forth considerable complaint regarding the value of the property entering into the property factor. The staff of the Franchise Tax Board studied the matter and found that in numerous cases the property factor exceeded the higher of the payroll and sales factors by 25 to 50 per cent or even more.

As a result of this study, the staff recommended that a public hearing be held on a proposed revision of the regulation under which an adjustment might be made in the California percentage of the property when land and improvements newly placed in use in the state causes the percentage of property within the state to exceed by more than 50 per cent the higher of the other two percentages of payroll and sales within the state. It was proposed, in such a case, that the ratio of land and improvements within California be reduced to the higher of the payroll or sales ratios. A hearing on the proposal was held, but the Board did not adopt the revised regulation. It was apparently the view of the Board that adjustments to the property factor for extreme cases could be made more equitably on an individual basis taking into consideration all the facts respecting the operations of the particular taxpayer than through the proposed general rule.

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<sup>62</sup> 18 CAL. ADM. C. Reg. 25101.

## B. Payroll

Payroll being employed as a factor because the services of individuals are an income-producing element, the payroll factor should include all compensation paid for such services whether in the form of wages, salaries, commissions or bonuses. The problem of definition as respects the payroll factor generally arises not as to the character of amounts paid employees, but rather as to the status of the one performing the service. The distinction to be made is that between employees and independent contractors or brokers. The term "agent" is of little use in this connection in view of its ambiguity. It is frequently used in a very general sense to cover a wide range extending from those who are actually employees to those who have little authority and act as independent contractors.

### *Employee, Independent Contractor or Broker?*

The controlling nature of the distinction was pointed out in *Irvine Co. v. McColgan*<sup>63</sup> involving a California corporation engaged in farming in this state and selling its products in other states solely through cooperatives and independent brokers. The cooperatives were held to operate as factors and were regarded as independent contractors. The court determined that the corporation represented in this manner outside the state was not doing business outside California and that all its income was, accordingly, allocable to this state. It stated that transactions engaged in *for* a foreign corporation in another state are not necessarily engaged in *by* the corporation in that state. The activities of the factors, brokers or independent contractors, accordingly, were held not to be those of the companies whose goods they sold for allocation purposes.

In the year preceding that of the decision of the California Supreme Court in the *Irvine* case, the District Court of Appeal stated in *Pacific Fruit Express Co. v. McColgan*<sup>64</sup> that the payroll factor should include amounts paid to out-of-state independent contractors for repairing and icing the refrigerator cars of the taxpayer. A concurring opinion objected to the inclusion of those amounts. The view of the majority on the point may be regarded as dicta, for the company was denied a recovery of any portion of the tax as redetermined by the Commissioner. In any event, the majority view became of no significance after the *El Dorado* decision.

### *"Doing Business" vs. "Source"*

While the *Irvine* case arose under section 10 of the Bank and Cor-

<sup>63</sup> 26 Cal. 2d 160, 157 P.2d 847 (1945).

<sup>64</sup> 67 Cal. App. 2d 93, 153 P.2d 607 (1944).

poration Franchise Tax Act when it was phrased in terms of doing business,<sup>65</sup> the distinction drawn by the court between employees and independent contractors has been applied by the Franchise Tax Board and the State Board of Equalization to situations arising under the subsequent income from sources within and without the state terminology. The State Board of Equalization in the *Appeal of Great Western Cordage, Inc.*,<sup>66</sup> held that activity by a corporation outside California was to be distinguished from activity for its account outside California by independent brokers from the standpoint of the source of income as well as that of doing business. Commissions paid to independent brokers or contractors were, accordingly, excluded from the payroll factor in this matter as well as in the *Appeal of Farmers Underwriters Association*<sup>67</sup> and *Appeal of The Times-Mirror Co.*<sup>68</sup>

It may be noted in passing that there is one difference between allocation under the earlier doing business and the present source phraseology of the statutory provision. Under the old provision, when the goods of a California company were sold outside the state only by independent brokers or firms as in the *Irvine* situation, all the income of the company was allocable to California even though a stock of goods was maintained by the company outside the state. Now, however, the goods outside the state would result, through the property factor, in the allocation of some of the income to sources outside California.

The distinction between employees and independent contractors is, of course, a double barreled proposition. Just as it resulted in a denial of an allocation of income to other states in the *Irvine* case, it can deprive California of allocable income. Goods manufactured outside the state by a foreign corporation are frequently sold in this state by an individual acting as an independent sales agent. The sales agent pays his own operating expenses, hires his own personnel and otherwise operates as an independent firm in the solicitation of orders for the manufacturer's products. He receives from the manufacturer commissions based on the sales resulting from his activities. Orders obtained by him are subject to acceptance by the manufacturer and the goods are shipped by the manufacturer directly to the purchaser. The

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<sup>65</sup> CAL. STAT. 1929, ch. 13 § 10, p. 24, as amended by CAL. STAT. 1931, ch. 1066 § 4, p. 2226, and CAL. STAT. 1935, ch. 275 § 6, p. 965.

<sup>66</sup> CAL. ST. BD. OF EQUAL., April 22, 1948; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13084.

<sup>67</sup> CAL. ST. BD. OF EQUAL., Feb. 18, 1953; CCH 1 CAL. TAX CASES ¶ 200-205; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13129.

<sup>68</sup> CAL. ST. BD. OF EQUAL., Oct. 27, 1953; CCH 1 CAL. TAX CASES ¶ 200-244.

Interstate Income Law<sup>69</sup> precludes the state from collecting a tax from the out-of-state manufacturer in this situation, but it requires no change in the California allocation practice either as respects the out-of-state manufacturer or a California manufacturer selling through independent sales agents or brokers in other states.

The Franchise Tax Board applies the definition of employee in the Federal Insurance Contributions Act<sup>70</sup> and the rulings thereunder as a standard for distinguishing employees from independent contractors, agents, brokers or other representatives.<sup>71</sup> That definition adopts the usual common law rules applicable in determining the employer-employee relationship and,<sup>72</sup> accordingly, embodies a control test in this regard. The payroll factor includes, then, all compensation paid for services rendered by individuals who receive direction as to the method or the details in which their duties should be executed but not by those who are responsible only for the accomplishment of certain results. The sales agent in the foregoing situation would not be regarded as an employee under that definition.

### *Location of Payroll*

Payroll is to be assigned to the state wherein the services are actually performed. The office or plant to which the employee is attached, the place of payment or the place from which control or supervision is exercised are not controlling. In the vast majority of cases, of course, the services will be performed in the state wherein the employee is stationed. If the services are performed partly within and partly without the state a breakdown must be made on a time, mileage or other suitable basis between the California and the out-of-state portion.<sup>73</sup> Merely occasional business trips to or from the state, as, for example, the annual or semi-annual visits of an officer to the branch offices of the corporation, of a buyer to a market center or of an officer or employee on a special assignment generally would be disregarded as too inconsequential. It is necessary to make the breakdown only when the trips to or from the state are made fairly regularly or when the trips are of somewhat more extended duration.

The 1957 amendment to Revenue and Taxation Code section 25101 relating to income derived from transportation by sea or air required a change in the Franchise Tax Board's apportionment of payroll as

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<sup>69</sup> 73 STAT. 555, 15 U.S.C.A. §§ 381-384 (Supp. 1959); P-H STATE & LOCAL TAX SERV. Cal. ¶ 13137.

<sup>70</sup> INT. REV. CODE OF 1954, §§ 3101-3125.

<sup>71</sup> Allocation instructions on the corporation income return form.

<sup>72</sup> INT. REV. CODE OF 1954 § 3121.

<sup>73</sup> 18 CAL. ADM. C. REG. 25101.



well as of property. Assignment of compensation of ocean-going vessel employees to California had been made on the basis of the number of port-days in this state to total port-days. For income years beginning after December 31, 1956, however, the California portion of the payroll of such employees is to be made on the basis of a ratio of the number of voyage days of the vessel within this state to the total number of voyage days of the vessel within the tax period.

### C. Sales

The term "sales" is employed in formula allocation not in the limited sense of transfers of title to property but in a broader or virtually gross receipts sense. Thus, amounts received as rentals or for various services are regarded as the proceeds of sales. There is to be included in the factor gross sales or receipts, less returns and allowances.<sup>74</sup>

Whether a sale occurs is to be determined from a realistic rather than a purely technical standpoint. For example, title to raw materials and work in progress had passed from an airplane manufacturer to the United States at an out-of-state plant under a cost-plus-a-fixed-fee contract, but due to the conversion of the contract to one on a fixed-price basis title to the property was returned to the manufacturer. Title to the finished product then passed again to the United States under the revised contract. The State Board of Equalization upheld the Franchise Tax Board's action in including only one of the sales in the sales factor, pointing out that the activity at the out-of-state plant as compared with that of the manufacturer in California was not affected in the slightest degree by the modification of the contract and the consequent two sales.<sup>75</sup>

### *Situs of the Sale*

Perhaps because it is more difficult to explain the use of sales as a factor determinative of the source of income than is the case for the property and payroll factors, there has been greater variation in the locating of sales than in the case of property and payroll. Among the definitions or tests that have been applied are the place of passage of title, the place of origin or place from which the goods are shipped to the purchaser, the place of destination or delivery point of the goods and the place at which the sales activity or solicitation occurs.<sup>76</sup>

California has adopted the activities or solicitation standard<sup>77</sup> as

<sup>74</sup> *Ibid.*

<sup>75</sup> Appeal of North American Aviation Inc., CAL. ST. BD. OF EQUAL., Oct. 7, 1952; CCH 1 CAL. TAX CASES ¶ 200-177; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13119.

<sup>76</sup> Hartman, *supra* note 10 at 71; ALTMAN & KEESLING, *supra* note 11 at 124.

<sup>77</sup> 18 CAL. ADM. C. REG. 25101; *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731, 215 P.2d 4 (1950); Appeal of Fourco Glass Co., CAL. ST. BD. OF EQUAL., April 20,

the one best fitted to indicate the source of income along with the property and payroll factors. Passage of title involves a legal conclusion based upon the construction of contracts, trade customs, the intention of the parties and other considerations in no way related to the source of income. The place of origin view frequently largely duplicates the weight given by the allocation formula to the state of manufacture through the property and perhaps also the payroll factors. The place of destination interpretation may result in the assigning of sales to states in which the company is not engaging in any activities at all and which may be without jurisdiction to impose a tax. It must be conceded, however, that the state of origin or state of destination views, and to a lesser extent the view based on passage of title, are considerably easier to apply than the activities or solicitation test. Sales activities frequently occur not solely within a single state but at times in as many as three or four.

The regulations<sup>78</sup> merely provide that sales or gross receipts generally shall be apportioned in accordance with employee sales activity of the taxpayer within and without the state. That activity may originate with a call by a salesman operating from a California branch office at a local office of a foreign corporation engaged in business in the state. Before the transaction is completed, however, a California employee of the purchaser may have visited offices or plants of the seller in other states or one or more out-of-state employees of the purchaser may have conducted negotiations with the seller's office in California or at offices or plants outside this state. If the customer desires a product tailored to his particular needs, the negotiations may include the services of engineers or other specialists whose activities may be conducted partly within and partly without the state.

Once again, judgment rather than hard and fast rules must govern the assignment of the sales. If only a slight portion of the activities leading to a sale is carried on outside California, the sale may be assigned entirely to this state. If, the sales negotiations follow a regular pattern of activities partly within and partly without the state, a portion of the total sales, e.g., 25 or 50 per cent, may be assigned to California on the basis of a review of the entire sales activity.

1960; CCH 3 CAL TAX CASES ¶ 201-542; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13225; Appeal of Cagney Productions Inc., CAL. ST. BD. OF EQUAL., April 21, 1959; CCH 2 CAL. TAX CASES ¶ 201-282; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13203; Appeal of Reno Liquor Co., CAL. ST. BD. OF EQUAL., Feb. 17, 1959; CCH 2 CAL. TAX CASES ¶ 201-248; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13201; Appeal of Screen Plays II Corp., CAL. ST. BD. OF EQUAL., June 25, 1957; CCH 2 CAL. TAX CASES ¶ 200-729; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13164; Appeal of Hammond Instrument Co., CAL. ST. BD. OF EQUAL., Jan. 29, 1948; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13080.

<sup>78</sup> 18 CAL. ADM. C. Reg. 25101.

The *Appeal of The United States Shoe Corporation*<sup>79</sup> illustrates the variety of situations encountered. Three of the 75 California customers of the corporation were dealt with not by the corporation's salesmen in California but by the president of the corporation exclusively. Orders for special "make-up" shoes were solicited from the three customers at offices outside California. Orders for "stock" shoes were generally placed by them by mail to the out-of-state office of the corporation. The president made two trips to California each year during which he visited the executives of these customers to discuss advertising and promotion, planning and business problems and generally to promote good will and maintain a close personal relationship.

The corporation treated the sales to the three customers as out-of-state sales. The State Board of Equalization, however, sustained the action of the Franchise Tax Board in assigning 50 per cent of the sales to California despite the fact that the president did not receive purchase orders in California from these customers. The objective of the trips to California obviously was the sale of shoes to them and it was the conclusion of the Board of Equalization that a substantial portion of the sales was the result of the regular activities of the president in this state. The Board refused to say that the 50 per cent figure was excessive in the absence of more detailed facts on solicitation than had been submitted to it by the corporation.

Solicitation of sales is not the only activity to be viewed in this connection. Sales may be made without any solicitation efforts at all. The mere receipt or processing of the order may be the only sales activity and mark the place of a sale. Repeat sales or sales made through reorders by customers without additional solicitation are assigned to the place of the original sale or sales from which they are an outgrowth.<sup>80</sup>

### *"Missionary" Work*

In one instance, at least, sales may enter into the sales factor computation even though no actual solicitation activity or even a receipt of orders is involved. This is the so-called "missionary" work situation in which employees of a manufacturer may seek to increase the sales of the company's products by holding demonstrations at retailers' places of business, assisting in the development of sales programs, service training, the introduction of new products or otherwise acting to achieve a greater distribution of those products. They do not seek orders and any that may be given to them are turned over to local independent distributors.

<sup>79</sup> CAL. ST. BD. OF EQUAL., Dec. 16, 1959; CCH 2 CAL. TAX CASES ¶ 201-441; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13215.

<sup>80</sup> 18 CAL. ADM. C. Reg. 25101.

If the sales of the company's products to the independent distributors are treated as California sales under the general solicitation or activities test, i.e., those sales are negotiated by employees of the company in this state, the missionary work would not result in the assignment of any additional sales to the state. But, if the sales to those distributors were negotiated outside California, a portion of the sales may be assigned, nevertheless, to this state.<sup>81</sup> The missionary services would not be continued if the manufacturer did not believe them beneficial from a sales standpoint. A middle ground between ignoring the services of the missionary employees in the sales factor or attributing all the sales of the manufacturer to the independent firms to the services of those employees seems in order. It is the usual practice of the Franchise Tax Board to attribute either 25 or 50 per cent of those sales to the missionary activities, the figure in any particular case depending on the extent of the services and the effect of the services on sales of the manufacturer's products in the state. The matter is one not susceptible of anything approaching precise measurement so unless the Board believes that at least a 25 per cent figure is warranted, it will seldom attribute sales to the missionary activity. The State Board of Equalization has upheld the Franchise Tax Board's practice of assigning sales on the basis of the missionary services.<sup>82</sup> In one case, 25 per cent of the sales of the products of one division and 50 per cent of the sales of the products of another division to California distributors were treated as California sales.<sup>83</sup>

The discussion in the payroll section regarding sales made through independent contractors or brokers is also applicable as respects the sales factor. Here, too, the activity of an independent firm in a state for the account of a manufacturer is not activity of the manufacturer in that state. The sales of the manufacturer are not to be assigned, accordingly, to the state in which they are negotiated or the orders obtained by the independent firms, but rather to the place at which the orders are accepted by the manufacturer.<sup>84</sup>

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<sup>81</sup> *Ibid.*

<sup>82</sup> Appeal of Smith, Kline & French Laboratories, CAL. ST. BD. OF EQUAL., April 20, 1960; CCH 3 CAL. TAX CASES ¶ 201-540; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13244.

<sup>83</sup> Appeal of Avco Mfg. Corp., CAL. ST. BD. OF EQUAL., Dec. 16, 1959; CCH 2 CAL. TAX CASES ¶ 201-438; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13214.

<sup>84</sup> *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731, 215 P.2d 4 (1950); *Irvine Co. v. McColgan*, 26 Cal. 2d 160, 157 P.2d 847 (1945); Appeal of Cagney Productions Inc., CAL. ST. BD. OF EQUAL., April 21, 1959; CCH 2 CAL. TAX CASES ¶ 201-282; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13203; Appeal of Caltex Sportswear Co., CAL. ST. BD. OF EQUAL., Jan. 20, 1954; CCH 1 CAL. TAX CASES ¶ 200-248; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13138; Appeal of Farmers Underwriters Ass'n, CAL. ST. BD. OF EQUAL., Feb. 18, 1953; CCH 1 CAL. TAX CASES ¶ 200-205; P-H STATE & LOCAL TAX SERV. Cal.

#### IV. Conclusion

The California taxing statute wisely grants a large measure of discretion to the tax administrator as respects the allocation of multistate unitary income. The phenomenal success of the state in obtaining the approval of its reallocation of income determinations by the courts and the State Board of Equalization furnishes strong evidence that the rules and practices of the administrator are well designed to effect an equitable apportionment of that income.

A heavy burden of proof is placed on the taxpayer to establish that a reallocation of its income results in the taxation of extraterritorial values. Alongside this burden, there should be a strong feeling of responsibility on the part of the tax administrator in applying its rules and practices to reach decisions in individual cases that are fair both to the taxpayer and the state.

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¶ 13129; Appeal of Great Western Cordage Inc., CAL. ST. BD. OF EQUAL., April 22, 1948; P-H STATE & LOCAL TAX SERV. Cal. ¶ 13084.